Devalued Dollars And Deep Deficits

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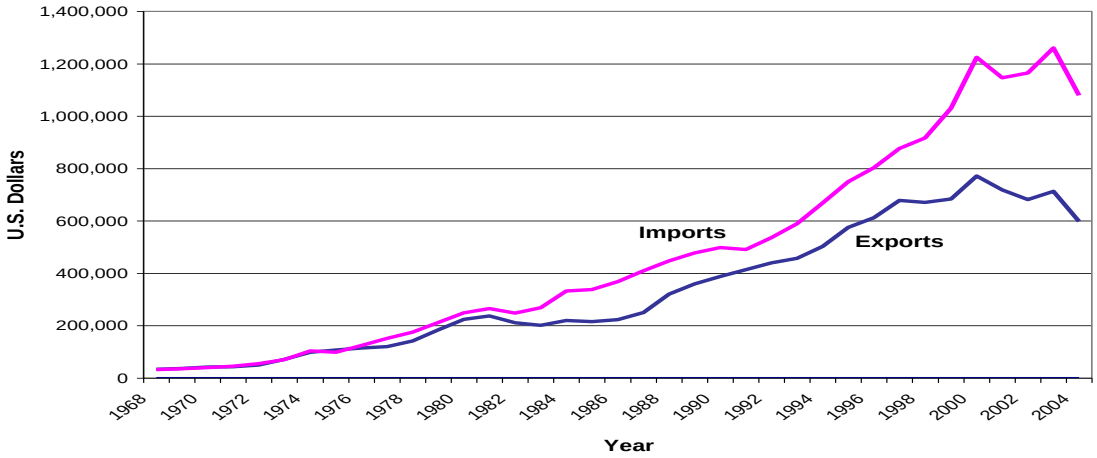
ABSTRACT

Devaluating a country's currency, according to long established theories, has two effects: it makes the country's imported products more expensive and its exported goods cheaper, thus reducing imports and increasing exports, helping the country's balance of trade. This paper examines the reasons why this theory did no have an effect on the US balance of trade, which for the last 30 years has been getting bigger every year, despite repeated devaluations of the dollar.

INTRODUCTION

In February 2005 the US Department of Commerce announced that the US trade deficit reached an all time high of $641 billion. (Chart 1)

Chart 1
US Imports & Exports 1969-2004



Source: Bank for International Settlements

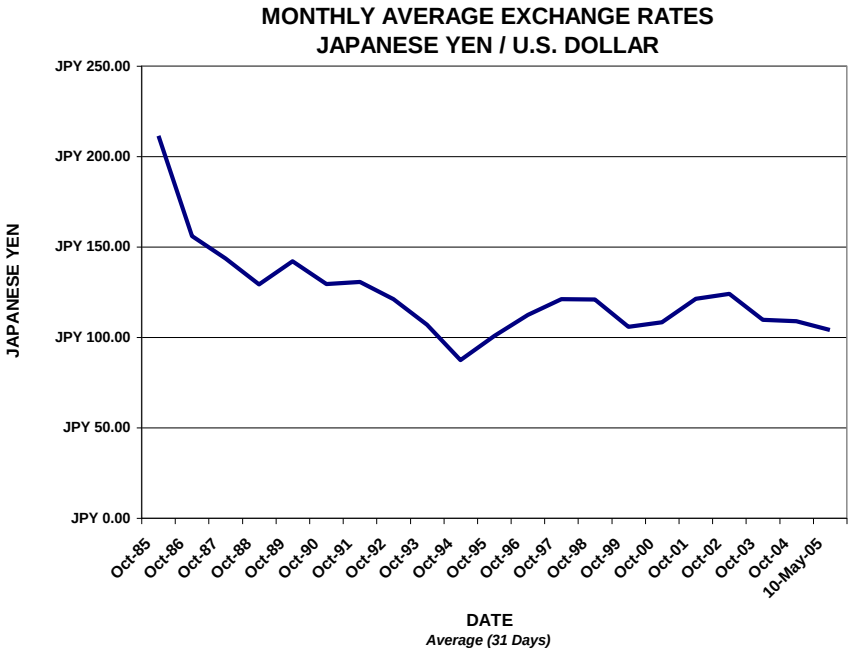
For years the US dollar has been devalued in the hope that a weaker dollar will help narrow the trade deficit that has being plaguing the US for more than 30 years. Indeed the value of the dollar in May of 2005, (104 yen), was less than half of its value in 1985, (214 yen), (Chart 2). A similar situation existed for over 20 years against the German mark, now incorporated into the euro, yet the trade deficit instead of getting smaller has reached an all time high.

According to a long established theory, a devalued currency makes a country's products cheaper and foreign goods more expensive, promoting exports and discouraging imports, thus improving the country's balance of trade. In practice this theory does not always work, especially in the wake of the accelerated globalization process and the rapid expansion of currency markets. While it is true is that trade deficits have an impact on currency values, the opposite is not always correct. The explanation to this seemingly contradictory phenomenon rests in the complexities of international finance, the multiple forces at work and the long lead-time involved.

THE OFFSETTING EFFECT OF OTHER CURRENCIES

While the US currency depreciated against the mark (and then the euro) and the yen, it *appreciated* against other currencies, like the Canadian dollar, the Mexican peso and currencies of other major US trading partners in Asia and Latin America, more than offsetting the devaluation against the mark and the yen. Indeed the Federal Reserve Bank of Dallas, using trade-weighted exchange rate indexes, calculated that, despite a decade- long effort by government policy makers, the dollar *appreciated* by 67 percent during that decade, 1985 and 1994. Moreover, over two dozen currencies are directly pegged to the US dollar and many others are partially linked, so when the US dollar is devalued these currencies are adjusted accordingly, neutralizing the effect of the devaluation. The Hong Kong currency, for example, has not changed much vis-à-vis the US dollar, despite the sharp drop in value of the latter against the mark and the yen.

Chart 2



Source: Bank for International Settlements

A WEAKER DOLLAR DOES NOT ALWAYS RESULT IN DECREASED IMPORTS AND INCREASED EXPORTS

The US dollar is not only an American currency, but is also a global exchange medium and a world reserve. The bulk of international trade is designated and paid for in US dollars, even when the US is not involved. Thus for example when Italy purchases oil from Kuwait or Denmark buys computers from Taiwan, payment is made in US dollars. A weak dollar may, in the long run, result in lower income, or even losses, to a German or Japanese firm when dollar revenues are sent back home and exchanged for the more expensive euro or yen, as was the case with Lufthansa, Daimler-Benz and Sony, but that does not necessarily trigger an increase in prices and a drop in demand for imports in the US. Eager to protect their hard-won market share in a highly competitive global economy, exporters to the US are reluctant to raise prices and opt instead for cost-cutting measures such as automation and robotics. (Japan now has more robots, both absolutely and per worker than the US). Out-sourcing, moving plants offshore, introducing up-scale models and reducing profit margins are other measures employed to keep prices low and to protect market share. On the other side of the coin, devaluating the US dollar does not always produce a commensurate decrease in the price of American products. Many companies are locked into multi-year contracts with suppliers and are not about to change their trade pattern any time a

currency value changes. Even when long term contracts are not present, merchants use the higher profit margins to compensate for lean years and to build up reserves for the next storm, and do not pass the lower cost to the ultimate user. Furthermore, a significant portion, over 50 percent, of international trade is intra-company trade, i.e. purchases by parent corporations from their overseas subsidiaries. Prices charged in these transactions are not a function of currency values, but are influenced by domestic cost factors and transfer pricing strategies designed to minimize tax liabilities. Thus for example, if the parent company is located in a high-tax country it will attempt to pay its subsidiaries high prices for components purchased and consequently show a lower taxable profit. Hence the price of a product is not proportionally affected by the value of the currency and the demand is not always directly a function of price. The Japanese yen, for example, is twice as high in 2005 as in 1985, but Japanese VCR's Camcorders, TV's and cars are nowhere twice as expensive as in 1985, and some are even cheaper.

LOWER PRICES DO NOT ALWAYS TRANSLATE INTO HIGHER DEMAND

Even when devaluation does result in lower prices it does not always translate into higher demand. Product quality, design, style and reputations for service and after-sale support are at times more important to consumers than a low price. The Yugo had a low sticker price but could not compete with the more-expensive Hondas and Toyotas. American cars are inexpensive in Japan yet are not in great demand, while the expensive BMW's and Mercedes are. In certain commodities, such as lumber, grain and other goods undistinguishable by brand name, a lower price can help increase demand and indeed in this sector the cheaper dollar helped the US balance of trade.

Even when devaluations do cause higher prices, they do not always result in lower demand for certain products. Some imports from Japan, like various memory chips, are not produced in the US and since the demand for these components is inelastic, higher prices have a minimal effect on the quantities imported. Sometimes, even when there are domestic substitutes, experience has shown that as soon as the price of imports rises, the price of domestic substitutes rises as well, undermining the effect of devaluations. Caterpillar, which argued that the value of the dollar is too high, hurting sales, increased its prices as soon as the dollar was devalued, negating the effect of the devaluation. At times a weaker dollar may, at least in the short run, widen the trade deficit as it takes more dollars to purchase the same quantity of goods as before, a phenomenon known as the *J curve* effect, i.e. the deficit sinks deeper before climbing up.

MERCHANDISE TRADE VS. CURRENCY MARKETS, THERE ARE SIGNIFICANT DIFFERENCES

Goods and currencies vary significantly in terms of valuation methods, trading volumes and transaction speed. The global volume of goods traded per year amounts to about 5-6 trillion dollars. Currencies are traded around the clock, at a volume of $2.4 trillion *per day* (Table 1). Two days of currency trading equal a whole year of merchandise flow.

The difference in transaction speed is even more striking. The bulk of merchandise moves on ships at 25 miles per hour. Currency travels at the speed of light, via satellite links, with the stroke of a key. Order cycle time for goods is measured in months and at times in years, while currency cycle time is denominated in seconds. The lag time from the point a devaluation takes place until it could have some effect on the price of merchandise is about 12-18 months. By then the economic weather has changed, many new factors have entered the market place and whatever ripple effect the devaluation could have had has been sterilized. Goods are traded by tens of thousands of traders, some as big as General Motors and others as small as a-one-person operation in Bombay. Currency trading is concentrated in seven major centers, London, New York, Tokyo, Singapore, Hong Kong, Zurich and Frankfurt, with the first three accounting for 60 percent of the total volume, (Table 1). The price of goods is determined through negotiations between importer and exporter and are often anchored into a long-term contract secured by a letter of credit. Currency prices change minute by minute and are influenced by speculations, political turmoil, social upheaval, economic uncertainties and psychological factors. An assassination south of the border can trigger a tidal wave of fleeing currencies, changing the financial equilibrium of a country while having little or no effect on the price of goods which, as was mentioned, are quoted in US dollars.

Table 1: Daily Currency Trading
(in billions of US dollars and percentages)

Country	1992		1995		1998		2001		2004	
	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%
UK	291	27.0	464	29.5	637	32.5	504	31.2	753	31.3
US	167	15.5	244	15.5	351	17.9	254	15.7	461	19.2
Japan	120	11.2	161	10.2	136	6.9	147	9.1	199	8.3
Singapore	74	6.9	105	6.7	139	7.1	101	6.2	125	5.2
Switzerland	66	6.1	87	5.5	82	4.2	71	4.4	79	3.3
Hong Kong	60	5.6	90	5.7	79	4.0	67	4.1	102	4.2
Germany	55	5.1	76	4.8	94	4.8	88	5.5	118	4.9
France	33	3.1	58	3.7	72	3.7	48	3.0	64	2.7
Australia	29	2.7	40	2.5	47	2.4	52	3.2	81	3.4
Denmark	27	2.5	31	2.0	27	1.4	23	1.4	41	1.7
Canada	22	2.0	30	1.9	37	1.9	42	2.6	54	2.2
Sweden	21	2.0	20	1.3	15	0.8	24	1.5	31	1.3
Netherlands	20	1.9	26	1.7	41	2.1	30	1.9	49	2.0
Others	91	8.7	140	9.0	212	10.6	170	10.2	252	10.3
Total	**1,076**	**100**	**1,572**	**100**	**1,969**	**100**	**1,621**	**100**	**2,409**	**100**

Source: Bank for International Settlements

CONFLICTING GOVERNMENT POLICIES

At times government officials use monetary policies, such as lowering interest rates, to try to achieve several goals: to stimulate the domestic economy, to lower the value of the currency and thus decrease the trade deficit. This strategy, while occasionally successful in the past, is now often neutralized by global markets. Lower interest rates can chase away capital, ending up hurting the local economy instead of helping it. This strategy may also offset the efforts of other government agencies to attract capital through generous and expensive incentive packages. Hence lowering interest rates, which often results in currency devaluation, does not yield the expected results in the global market place.

THE CONSEQUENCES OF PROLONGED TRADE DEFICITS

Since policy makers were unsuccessful in closing the US trade deficit despite the drastic measures they applied, some of them argue that there is no harm in having trade deficits and that there is no need to rock the boat. After all the US has lived with a trade deficit for over thirty years without immediate visible damage. In reality a protracted trade deficit is harmful and can cause domestic dislocations. First, a trade deficit adds to the national debt burden, which is already substantial. In 2004 the US government spent more than $322 billion in interest payments to service this debt (for the first 4 months of 2005 the figure is already $167). For comparison, the budget for the Department of Education is $61 billion and for the Department of Transportation $56 billion. [1.] Each annual trade deficit increases the debt and the debt-service cost. Second, companies that cannot sell their products, are forced to scale down operations, and occasionally to export the entire plant, throwing the workers overboard. For each $1 billion drop in exports the US loses 20,000 jobs so when the trade deficit plummeted from $346 billion in 1999 to $ 641 billion in 2004, six million jobs were lost. Lost jobs translate into unemployment, lower government revenues, higher social expenditures, increased government deficits, higher interest rates and a lower standard of living.

CONCLUSION

Devaluing a currency in order to gain trade advantages is a quick fix, a fast cure concocted to get something for nothing. There are no short cuts and no instant remedies in the cut-throat, competitive global market place. Japan, a feudal agrarian economy for centuries, did not evolve into an industrial power house through some monetary gimmicks. At the beginning of the 20th century an Australian consultant hired by the Japanese government, described the Japanese workers as lazy and "easy going" and depicted Japanese products as "inferior goods". Following is a quote from the study published in 1915:

Japan commercially, I regret to say, does not bear the best reputation for executing business. Inferior goods, irregularity and indifferent shipments have caused no end to worry…. My impression as to your cheap labour was soon disillusioned when I saw your people at work. No doubt they are lowly paid but the return is equally so; to see your men at work made me feel that you are a very satisfied easy going race who reckon time is no object. When I spoke to some managers they informed that it was impossible to change the habits of national heritage

Hard work, frugality, a healthy savings rate, long-range investment strategies, high quality products, an effective educational system and supportive government policies have transformed a feudal agricultural economy into an advanced industrial giant. By 1960 Japan was already exporting Toyotas to the US. A weak currency does not reflect a strong economy. Germany, Japan and Switzerland have strong currencies and trade surpluses, while countries with weak currencies have trade deficits. During the 1960s the US dollar was a strong currency worth 4 German marks and 300 yen, yet the US enjoyed a trade surplus through the whole decade. Since 1971the US has experienced a trade deficit in every year except two, (1973 and 1975), and also has a much weaker currency. For instance in 1995 the US dollar was only worth 1.4 DM and 93 yen, yet the US then had balance of trade deficit of $174 billion.

Since successive devaluations of its own currency have not reduced the trade deficit, the US is now turning to the other side of the coin: pressuring other countries, especially China, to revalue their currencies, a reversed version of the same gimmick. It is not China or Japan's fault that the US has a trade deficit; it is our own house that must be put in order. Economists agree that even if China revalues its currency the impact on the US trade balance will be minimal. Reversing the generation-long slide and pushing the US economy uphill will require considerable cooperation and sacrifice. Since no single sector in the economy caused the massive trade deficit, no one sector can reverse it. It will take a concerted and prolonged effort by the private sector, government, labor, consumers and workers to accomplish the task. Government can do its share by cutting its own deficit, by borrowing less and by overhauling the costly health care system that places US companies at a competitive disadvantage vis-à-vis foreign competitors. New legislation is needed to promote research and development, encourage savings and permit cooperation between American enterprises in risky overseas ventures. More cooperation will also be needed between government and business as is the case in Japan and Germany. American corporations can compete against individual Japanese or Chinese firms, but cannot compete against an alliance of Japanese conglomerates and the Japanese government.

Labor unions will have to contribute their share, starting with a fundamental change in attitudes from the traditional adversarial confrontational approach to a more cooperative mode. Unions and management are in the same boat and will have to pool their resources and work together as one crew. In the competitive global economy, the union's adversary is not U.S. management but foreign competitors. They are the ones who take over markets and gain jobs. Unions will have to cooperate to increase productivity and improve quality; otherwise our industry will continue to sink, bringing down both unions and management. Management, in turn, will have to become less self-centered and more employee-oriented. By their own conduct and concern for their workers and the company, managers can serve as an example for employees and provide inspiration and motivation.

In a complex technological society where research, know how and information are vital, the U.S. cannot afford to lag behind its competitors in educational achievements. Because of our high wages, the U.S. cannot compete today in manufactured goods; soon, low educational levels will render the U.S. noncompetitive in high-tech areas, as well. Here, too, a cooperative effort on the part of parents, teachers, students, and local government will be needed to upgrade educational standards and raise achievement levels. Consumers will have to do their share by consuming less and saving more. This would become more feasible, and even attractive, if tax laws would reward savings and tax consumption. Since so many consumer goods are imported, cutting consumption would, by itself, reduce the trade deficit. Increased savings would provide the necessary capital to modernize American industry, making it more competitive in the international marketplace, able to sell its products and increase exports.

More than two hundred years ago Benjamin Franklin wrote: "use it up, wear it out, make it do, or do without." Never was such advice to save, be frugal, reduce waste, and forgo consumption more appropriate than now. While the damage from a protracted trade deficit could be severe, this fact is not always obvious to the public at large. Hence, there is neither political pressure nor constituent push to take appropriate measures. On the contrary, because

of widespread misconceptions, public pressures are often in the wrong direction. When a company is unable to modernize its plant (because of inadequate tax incentives and high capital costs) and consequently ends up closing the plant, the blame is often placed on the company. Constituents then pressure their representatives to pass restrictive legislation prohibiting or postponing plant shut downs. This perpetuates old and unproductive plants that are hard pressed to compete internationally.

Lowering the value of the dollar will not cure these structural and deep-rooted problems of American industry and society. It can, at best, yield a marginal, short-term, and superficial improvement. To reverse the downhill slide in the trade balance would require a sustained and comprehensive effort on the part of the political, financial, and economic leadership of this country. Without such a total commitment and concerted effort, this formidable task cannot be accomplished, and the U.S. trade balance and national debt will continue to worsen, rendering the US a second rate power, following in the footsteps of great-have-been powers like Egypt, Spain, Greece, and Portugal.

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